COMMENTS

IS GIFTING DEAD IN CHAPTER 11 REORGANIZATIONS? EXAMINING ABSOLUTE PRIORITY IN THE WAKE OF THE SECOND CIRCUIT'S NO-GIFT RULE IN *IN RE DBSD*

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INTRODUCTION

In the context of a Chapter 11 reorganization, a debtor in possession historically has had a significant amount of flexibility in crafting a plan of reorganization. During the recent reorganization of communications company DBSD North America, Inc. (hereinafter "DBSD"), however, the doctrine of gifting—which has at times lent itself to creativity on the part of corporate debtors—was significantly restricted. The doctrine known as "gifting" in the context of the Bankruptcy Code is one, which, in its modern development, had evolved from a limited origin in 1993 to a more expansive use over the following decade. Courts had frequently confirmed plans of reorganization where creditors "in the money" voluntarily shared some of their proceeds with those "out of the money" for various strategic purposes. Some insist that this framework encourages creativity in restructuring, while others characterize the practice as a method of short-circuiting the seniority-based distribution scheme controlling bankruptcy and diverting a debtor's scarce available proceeds in violation of the Bankruptcy Code. The practice had frequently been treated with approval

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by the bankruptcy courts, but now it has been largely gutted as a result of the Second Circuit's decision in *Dish Network Corp. v. DBSD North America, Inc. (In re DBSD)*,[1] taken in combination with a Third Circuit ruling from 2005 that also held improper the confirmation of a plan involving gifting.[2] The Second Circuit in *DBSD* overruled both the bankruptcy court and the district court and applied a narrow interpretation theory to the provision in the Bankruptcy Code often referred to as the absolute priority rule.[3]

The Second Circuit's decision raises some important questions about the future of creative reorganization practices. This Comment takes the position that the decision creates a circuit split that is not fully acknowledged by the courts and, as such, is an important issue that should be adjudicated by the Supreme Court. This Comment will argue that, although the *DBSD* court appears to have interpreted the Bankruptcy Code correctly, there are some difficulties with the Second Circuit's reasoning. Specifically, the court strained to avoid rejecting a prior First Circuit approach,[4] possibly to avoid explicitly declaring a circuit split. This Comment will argue that, in reality, a split has developed between the First Circuit and the Second and Third Circuits based on their recent decisions in *DBSD* and *Armstrong*. The *DBSD* decision also calls into question what is known as the "New Value Corollary," which is a more frequently used strategy than gifting in Chapter 11 corporate reorganizations. As a result of the most recent decision, what remains is a confusing web of rules on gifting that constitutes a circuit split in all but name.

The 2005 *Armstrong* decision appears to have carefully avoided rejecting the First Circuit's *In re SPM Manufacturing Corp.* decision. And now the 2011 *DBSD* decision was careful to claim that its holding was in harmony with both of those prior circuit decisions. Yet each of the three opinions lays out a different approach to determining when gifting is or is not appropriate, and each conflicts with the others in important ways. This Comment will argue that gifting is a more problematic doctrine than new value, both from a policy perspective and from a textual one. The Comment will further argue that, should the Supreme Court agree to hear a case involving the gifting doctrine, the meaning of the applicable statute in the Code can be clarified, and the pall cast over the new value corollary will be lifted. With the meaning of the code clear on both doctrines, practitioners can then lobby Congress to amend the Code to allow gifting in

1. 634 F.3d 79 (2d Cir. 2011) [hereinafter *DSBD*].
2. *In re* Armstrong World Indus., 432 F.3d 507 (3d Cir. 2005).
3. 11 U.S.C. § 1129(b)(2)(B) (2012).
4. *In re* SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993).

limited circumstances the next time the code is amended if they believe that the doctrine is important enough to successful complex reorganizations.[5]

I. THE ORIGINS AND RISE OF GIFTING

A. Early Origins

The propriety of what is currently termed "gifting" can be traced back to *Northern Pacific Railway Co. v. Boyd*,[6] a 1913 Supreme Court case that reined in creative reorganization practices. As a receivership bar grew in the years leading up to *Boyd*, reorganizations, almost exclusively involving railroads,[7] had become increasingly complex and creative.[8] In order to address what was seen as collusion in railroad reorganizations, wherein railroad owners often would retain control of an interest in the entity after receivership proceedings, while some creditors would be excluded from recovery, the judge-made "absolute priority rule" emerged.[9] In *Boyd*,

5. During the final phase of preparation for publication, another student comment was published discussing some of the material in this comment. *See* Lauren E. McDivitt, Comment, *What Do You Mean There Won't be Gifts This Year?: Why Practitioners Cannot Rely Upon Gifting Provisions in Chapter 11 Reorganization Plans in the Fifth Circuit*, 44 TEX. TECH L. REV. 1019 (2012). After tracing the history of the gifting doctrine through *DBSD*, the author proposes that the Fifth Circuit may not approve of plans involving gifting. *Id.* at 1039-45. The author arrives at this conclusion by analyzing two Fifth Circuit cases that she finds instructive and also writes that the Fifth Circuit may find *DBSD* "more persuasive" than prior cases from other circuits. *Id.* at 1044-45. Further, the author suggests workarounds for practitioners where gifting might otherwise have been utilized. *Id.* at 1045-50. This Comment, on the other hand, does not focus on the application of this line of cases in any particular circuit. Instead, it proposes that a circuit split that has not been fully acknowledged exists in this area of the law and suggests that the issue is ripe for consideration by the Supreme Court. This Comment also observes how the *DBSD* ruling might be interpreted to call into question another doctrine used at times by creative practitioners, the new value doctrine. In conclusion, this Comment suggests a judicial framework wherein these issues could be resolved in a manner that is both practical and consistent with the objectives of the Bankruptcy Code.

6. 228 U.S. 482 (1913).

7. *See* Robert T. Swaine, *Reorganization of Corporations: Certain Developments of the Last Decade*, 27 COLUM. L. REV. 901 (1927) (noting that as of 1916, over eighty railroads were in receivership, representing about sixteen percent of the total rail mileage in the United States).

8. *See* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA 66 (2001) (describing *Boyd* in detail and explaining why it was a "major judicial setback" for receivership lawyers).

9. *See In re* Iridium Operating LLC, 478 F.3d 452, 463 n.17 (2d Cir. 2007) (explaining that "[t]he absolute priority rule originated as a 'judicial invention designed to preclude the practice in railroad reorganizations of 'squeezing out' intermediate unsecured creditors through collusion between secured creditors and stockholders (who were often the same people.'")) (quoting *In re* Wabash Valley Power Ass'n, 72 F.3d 1305, 1314 (7th Cir.

stockholders had been allowed to participate in the reorganization of the Northern Pacific Railroad upon paying an assessment, while certain unsecured creditors were excluded from the plan.[10] This had become a common practice, where shareholders would contribute capital to a reorganized entity, yet existing unsecured creditors would be excluded.[11] After the equity receivership court approved the plan, an unsecured creditor sued the reorganized railroad on the theory that stockholders had received an interest in the new company, while unsecured creditors were shut out, violating the proper priority of distribution.[12] By a 5-4 vote, the Supreme Court held that a transfer by a bondholder—or in the parlance of Chapter 11 reorganizations, a secured creditor—to stockholders was invalid, and the unsecured creditor could pursue its claim, even though the bondholder had no obligation to make the transfer, and had to give up value that it had rightful claim over in order to make the transfer.[13] The court found that "[a]ny device . . . whereby stockholders were preferred before the creditor was invalid [under the Bankruptcy Act]."[14] The "fair and equitable" rule that came out of *Boyd* thus came to be a vertical test that ensures that liquidation or reorganization proceeds are distributed in order of priority of claims, and no creditors or classes of creditors are skipped in favor of more junior creditors or equity holders.[15] The *Boyd* rule became known as the "fixed principle," standing for the notion that equity was never to be paid when debt was not first paid in full.[16] But *Boyd* did not use the term "absolute priority," and it was not initially clear that such a rigid rule was demanded. In the wake of *Boyd*, some practitioners, led by Robert Swaine, a prominent reorganization lawyer of the time, argued that *Boyd* demanded only "relative priorit[y]."[17] Swaine predicted, ultimately incorrectly, that future courts interpreting *Boyd* would only require that each class retaining

1995)); Skeel, *supra* note 8 at 56-59 (providing a history of the railroad equity receiverships in the period leading up to *Boyd*).

10. *Boyd*, 228 U.S. at 504.
11. Skeel, *supra* note 8, at 67.
12. *Boyd*, 228 U.S. at 498.
13. *Id.* at 502.
14. *Id.* at 504.
15. *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 118–19 (1939) (declaring that the *Boyd* doctrine interpreting the term "fair and equitable," found in the Bankruptcy Act of 1898, is "firmly imbedded" in the Act).
16. *See* Harvey R. Miller & Ronit J. Berkovich, *The Implications of the Third Circuit's* Armstrong *Decision on Creative Corporate Restructuring: Will Strict Construction of the Absolute Priority Rule Make Chapter 11 Consensus Less Likely?*, 55 AM. U. L. REV. 1345, 1349 (2006) (describing the history of *Boyd* and noting that the rule that came out of it was one requiring that equity must never be paid in a reorganization if creditors are not paid in full).
17. Swaine, *supra* note 7, at 907.

an interest in the reorganized entity retain its "relative position" in relation to other security holders, which would not prevent offers to participate in the reorganized entity from being extended to the various classes, so long as the offers were fair given the position of each class.[18] Swaine even maintained that such a broad interpretation of *Boyd* as the one ultimately taken would make "successful corporate reorganizations impossible," because equity holders are often the only source of new capital, and their participation is often essential and frequently can only be obtained by giving the stockholder something of value exceeding any new capital it contributes.[19] Partially in response to Swaine's argument for a "relative" priority rule, in a debate played out over the pages of the Columbia Law Review, James C. Bonbright and Milton M. Bergerman termed *Boyd*'s requirement an "absolute priority" rule.[20] Bonbright and Bergerman saw a danger in failing to impose a strict absolute priority test. They argued that in railroad reorganizations, junior security holders consistently received returns at the expense of senior security holders, even beyond the extent necessary to raise new capital.[21] In the end, it was the absolute rule that won out in the courts.[22] This common law rule was later codified in the 1978 Bankruptcy Code at § 1129(b)(2)(B)(ii), which provides in relevant part that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property."[23] Under the enactment of the Code, however, the absolute priority rule only took effect if an objecting class of creditors existed.[24]

18. *Id.* at 907–08, 912. In essence, Swaine argued that equity still retained a going concern value in a reorganization, which *Boyd* did not require be zeroed out, as in a liquidation. *Id.*

19. *Id.* at 915.

20. James C. Bonbright & Milton M. Bergerman, *Two Rival Theories of the Priority Rights of Security Holders in a Corporate Reorganization*, 28 COLUM. L. REV. 127, 130 (1928).

21. *Id.* at 144. Bonbright and Bergerman observed that courts in the wake of *Boyd* tended not to upset a plan which was supported by a "substantial majority" of bondholders just because it violated absolute priorities, as long as approximate relative priorities were maintained. However, they called on the Supreme Court to require absolute priority if and when the issue came before it. *Id.* at 155–56.

22. *See* Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 107 (1939) (Supreme Court's adoption of absolute priority rule).

23. 11 U.S.C. § 1129(b)(2)(B)(ii) (2012); *see also In re* Snyder, 967 F.2d 1126, 1128 (7th Cir. 1992) (explaining that § 1129(b) codified the absolute priority rule, although under the Code a plan may be confirmed by the consent of the impaired classes pursuant to 11 U.S.C. §1126(c), which was an alteration of the common law rule).

24. 11 U.S.C. § 1129(b)(2)(B)(ii) (2012).

B. SPM—The Origin of Gifting Under the Modern Bankruptcy Code

The origin of gifting under the modern Bankruptcy Code is generally traced to the First Circuit's decision in *In re SPM Mfg. Corp*.[25] The debtor in *SPM* originally filed in Chapter 11; however, the proceeding was later converted into a Chapter 7 liquidation after difficulties confirming a reorganization plan.[26] In *SPM*, a perfected first-priority secured creditor had a $9 million claim,[27] while the debtor's assets were only worth $5 million.[28] Next in order came a tax claim that was a priority unsecured claim, and that the owners of the debtor corporation were personally liable for in the event it was not satisfied under the plan.[29] In order to secure cooperation of the unsecured creditors' committee while the plan was still in Chapter 11, the secured creditor agreed to share, on a sliding scale basis, the proceeds of the eventual liquidation or reorganization with the class of general unsecured creditors, but not satisfy the tax debt constituting the priority unsecured claim.[30] The agreement called for not only the satisfying of the committee's attorney's costs and fees, but also a sharing of the proceeds above and beyond such a carve out.[31] After the plan was converted to a Chapter 7 liquidation, the debtor took a position against the gifting, evidently because the owners of the family enterprise would otherwise owe the priority unsecured debt personally.[32] The unsecured creditors' committee argued that once the proceeds were distributed to the sole creditor that was entitled to receive anything in liquidation, the funds were no longer part of the estate and the creditor could do as it wished.[33]

The First Circuit agreed, overruling both the bankruptcy court and the district court.[34] A class that is "in the money" might want to share some of its proceeds with a class that is "out of the money" in order to avoid litigation, retain old management, secure cooperation, or achieve other strategic goals. The First Circuit pointed out that just as the Code would permit a priority creditor to voluntarily convey funds "to some or all of the general, unsecured creditors after the bankruptcy proceedings finished," so

25. 984 F.2d 1305 (1st Cir. 1993) [hereinafter *SPM*].
26. *Id.* at 1308.
27. In essence, this means that the creditor had the first right to any monies received by the bankruptcy estate. This first-priority creditor was secured by a lien against substantially all of the debtor's property. *Id.*
28. *Id.* at 1307.
29. *Id.*
30. *Id.* at 1308.
31. *Id.*
32. *Id.*
33. *Id.* at 1313.
34. *Id.*

could a secured creditor "enter into a contract *during* bankruptcy in which it promises to do the same thing."[35] The First Circuit also held that the distribution scheme under the Bankruptcy Code "does not come into play until all valid liens on the property are satisfied,"[36] and because the secured claim absorbed all of the debtor's assets, no one else had a claim of right to those assets under the Bankruptcy Code.[37]

As might be expected, the *SPM* holding invited practitioners to test how broadly courts might be willing to construe its reasoning, and in general, creative restructuring agreements were met with success over the following decade. As Daniel Bussel and Kenneth Klee put it, "SPM-ing became all the rage" once Bankruptcy lawyers realized that courts were allowing senior creditors to make deals with "junior juniors" without providing for intervening classes.[38] One decision confirmed a plan involving "gifts" made directly from the estate by unsecured, rather than secured, creditors in the context of a Chapter 11 reorganization confirmation: all circumstances differing from the *SPM* facts.[39] Other courts confirmed plans that involved gifting not to unsecured creditors, but to equity.[40] Gifting came to be seen by many practitioners as a way to encourage creative deal making that increased overall value, and discouraged holdout behavior.[41] Parties "out of the money," they reason, will always object and litigate if possible, not because they were unfairly circumvented and deprived of a legitimate claim, but to use the threats of litigation and delay to extract value for themselves. Allowing these classes to receive a consensual gift could serve to prevent such value-destroying measures.[42] Many of the subsequent cases broadening the doctrine cite in support the reasoning of *SPM* that "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including to share them with other creditors."[43] As a failsafe, proponents of gifting argue that the Best Interests Test ensures that a plan cannot be confirmed

35. *Id.*
36. *Id.* at 1312.
37. *Id.*
38. Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 711 (2009).
39. *In re* MCorp Fin. Inc., 160 B.R. 941 (S.D. Tex. 1993).
40. *See, e.g.*, *In re* Genesis Health Ventures, Inc., 266 B.R. 591 (Bankr. D. Del. 2001) (confirming a plan that conveyed a gift to equity).
41. *See* Miller & Berkovich, *supra* note 16, at 1349 (arguing that permitting gifting furthers the policy objectives of Chapter 11).
42. For a detailed discussion of the history of the absolute priority rule and the gifting doctrine, see *id.* at 1349-68.
43. *SPM*, 984 F.2d at 1313; *see also In re* Journal Register Co., 407 B.R. 520 (Bankr. S.D.N.Y. 2009) (citing *SPM* for the rule that creditors can do what they wish with bankruptcy proceeds they receive).

over the objection of a creditor that would receive less than it would have in a liquidation proceeding.[44] In any event, by the mid-2000's, it was becoming more common for shareholders to get a piece of the reorganization pie, a trend that certainly included other phenomena besides increased use of gifting.[45] One practitioner credited the increase in shareholder recoveries in the early part of the decade to "public outcry over the way shareholders' fates were dealt with" in some of the large Chapter 11 filings such as Enron.[46]

C. *Armstrong case narrows the use of gifting.*

In 2005, a circuit court visited the gifting doctrine for the first time since *SPM* in *In re Armstrong World Indus., Inc.*[47] *Armstrong* rejected the particular plan that had been confirmed by the bankruptcy court on the grounds that the plan violated the plain language of the absolute priority rule.[48]

Armstrong was characterized by some as a test on only the outer limits of gifting. The proceeding involved an attempt by one class of unsecured creditors to "cram down" another class of unsecured creditors and gift to equity.[49] Equity holders who wished to secure warrants in the reorganized debtor reached an agreement with a class of personal injury claimants, who were themselves anxious to get into the money.[50] The personal injury claimants agreed to transfer warrants to the equity holder in the event that another unsecured creditor rejected a previously proposed plan under which the equity holders would obtain the warrants.[51]

The bankruptcy court approved the plan,[52] but after the district court overturned the confirmation,[53] the Third Circuit upheld the district court's ruling that the plan violated the absolute priority rule as adopted by the

44. *See* 11 U.S.C. § 1129 (a)(7)(A)(ii) (2012) (codifying the Best Interests Test in Chapter 11); 11 U.S.C. § 1325 (a)(4) (codifying the test for Chapter 13 proceedings); Miller & Berkovich, *supra* note 16, at 1374 (arguing that the "Best Interests Test" protects creditors from the abusive uses of gifting that *Boyd* was concerned with preventing).

45. Lingling Wei, *Holders Find Voice in Bankruptcies*, WALL ST. J., Mar. 26, 2003, at B4F.

46. *Id.* (quoting Edward Weisfelner of Brown Rudnick Berlack & Israels LLP).

47. *In re* Armstrong World Indus., Inc. (*Armstrong II*), 432 F.3d 507 (3d Cir. 2005).

48. *Id.* at 514. For a thorough history of the holding in *Armstrong*, see Miller & Berkovich, *supra* note 16, at 1412–18.

49. *Armstrong II*, 432 F.3d at 509–10.

50. *Id.* at 509.

51. *Id.*

52. *In re* Armstrong World Indus., Inc. (*Armstrong I*), 320 B.R. 523, 524 (D. Del. 2005).

53. *Id.*

Bankruptcy Code.[54] The Third Circuit was careful to distinguish its holding from *SPM*, noting that since *SPM* involved a distribution under Chapter 7, the absolute priority rule was not implicated.[55] The court noted that in *SPM*, the gifting party had a perfected security interest, thus making the property free from subjection to distribution under the Code's scheme,[56] and that the *SPM* distribution was a "carve out."[57]

II. *DBSD*

As a Third Circuit decision, *Armstrong* was binding on the courts in the District of Delaware, one of the most common forums for large corporate bankruptcies.[58] The other large forum, the Southern District of New York, did not have a circuit opinion on the topic until *DBSD* came along in 2011. In fact, the Second Circuit had avoided answering the question just four years earlier,[59] but took the issue head-on in the *DBSD* case.

A. The Facts

Prior to filing for bankruptcy, DBSD had been a subsidiary of ICO Global, which formed it to develop a mobile communications network

54. *Armstrong II*, 432 F.3d at 518.

55. *Id.* at 518. The *Armstrong* holding does not attempt to distinguish, however, the fact that the gifting agreement in *SPM* was made while the case was still in Chapter 11, and the *SPM* court clearly indicates it would have blessed the agreement even if it had stayed a Chapter 11 case. *See In re* SPM Mfg. Corp., 984 F.2d 1305, 1317 (1st Cir. 1993) ("[W]e cannot find support for appellees' assertion that this agreement conflicts with any policy in favor of reorganizations manifested by Chapter 11.")

56. *Armstrong II*, 432 F.3d at 514.

57. *Id.* Note that the *Armstrong* characterization of the *SPM* agreement as a "carve out" is inconsistent with the common use of the term. The *SPM* plan called for payment of proceeds net of administrative expenses to the unsecured creditors on a sliding scale, starting at ten percent to the unsecured creditors for the first $3,000,000 of net proceeds. *SPM*, 984 F.2d at 1308. *But see* Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445 (2002) ("As generally used, a carve out is an agreement between a secured lender, on the one hand, and the trustee or debtor in possession . . . on the other, providing that a portion of the secured creditor's collateral may be used to pay administrative expenses.").

58. *See* ED FLYNN & GORDON BERMANT, BANKRUPTCY BY THE NUMBERS 3, http://www.justice.gov/ust/eo/public_affairs/articles/docs/abi_032002.pdf (last accessed Nov. 28, 2012) (stating that over a recent six year period, of the 105 largest bankruptcies, 56 were filed in the District of Delaware, and 18 in the Southern District of New York, while no other single district had more than 3).

59. *See In re* Iridium Operating LLC, 478 F.3d 452, 460–61 (2d Cir. 2007) (declining to decide whether *SPM* applied to Chapter 11 settlements because the case could be decided on other grounds).

using satellites and transmission towers.[60] In May 2009, DBSD filed for Chapter 11 bankruptcy, listing $813 million in liabilities and $627 million in assets.[61] A first-priority creditor with a security interest in substantially all of DBSD's assets had a perfected lien in the amount of $40 million.[62] A second-priority creditor who also held a security interest in substantially all of the debtor's assets had a lien totaling $740 million at the time of filing.[63] The combined amount owed to these two creditors plainly exceeded the total assets of the company. Following just as plainly is the fact that had it been a liquidation, these two secured creditors would have had the right to take DBSD's assets in their entirety, with nothing left over for unsecured creditors or equity holders. These two, however, were not the only creditors. Sprint Nextel had an unliquidated and unsecured claim that was based upon a pending lawsuit.[64]

DBSD ultimately proposed a reorganization plan wherein the first-priority creditor would receive new debt in the reorganized entity, and the second-priority creditor would receive the majority of the common stock in the reorganized company, worth between fifty-one and seventy-three percent of its original claims.[65] Under the proposed plan, Sprint would receive equity worth four to forty-six percent of its original claim,[66] and the existing shareholder would receive approximately five percent of the equity in the reorganized entity.[67] Sprint objected to the confirmation of this plan.[68] Because Sprint was not entitled to recover from a liquidation perspective, as the bankruptcy court pointed out, its recovery was "based, ironically, on the gifting to which it object[ed]."[69]

B. The Holdings

Judge Gerber of the Bankruptcy Court in the Southern District of New York approved the plan over Sprint's objection on absolute priority rule

60. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79, 85 (2d Cir. 2011).
61. *Id.* at 86.
62. *Id.*
63. *Id.*
64. *Id.*
65. *In re* DBSD N. Am., Inc. (*DBSD I*), 419 B.R. 179, 187-88 (Bankr. S.D.N.Y. 2009).
66. *Id.* at 188.
67. *Id.* at 187.
68. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79, 85 (2d Cir. 2011). Although acceptance or rejection of a plan is administered on a class-by-class and not creditor-by-creditor basis, evidently Sprint's claim made up a large enough portion of the unsecured debt that Sprint's vote was sufficient alone to cause the unsecured class to reject the plan. Ralph Brubaker, *Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!,"* 31 No. 4 BANKR. LAW LETTER 1 (Apr. 2011).
69. *DBSD I*, 419 B.R. at 215.

grounds.[70] Judge Gerber relied on *SPM*, pointing out that the gifting doctrine permits senior creditors to convey to junior classes or interests part of the distribution they would otherwise be entitled to.[71] Noting *Armstrong*, which he recognized that the Southern District of New York was not bound by, he wrote that it distinguished rather than rejected *SPM*, and that specifically, it only rejected gifting by unsecured creditors.[72] He suggested that the *SPM* court would have approved of the gifting scenario involving DBSD, since in a case where secured creditors are doing the gifting, the rationale in favor of the doctrine is stronger, since the creditor has a property interest in that which it is gifting.[73] The district court in turn affirmed the bankruptcy court's holding on the absolute priority rule issue, finding Sprint's appeal to be without merit in a short portion of its opinion in which no cases were cited.[74]

The case next came up for appeal before the Second Circuit on three issues, one of which was whether, under the Bankruptcy Code, a secured creditor in a Chapter 11 proceeding can "gift" some of its proceeds from a reorganization plan to an equity holder, over the objection of a class of unsecured creditors, when the unsecured creditors would have received nothing under a pure liquidation dissolution.[75] The Second Circuit overturned the ruling of the bankruptcy court and district court, holding that the DBSD plan violated the absolute priority rule.[76] Although the Second Circuit did heavily rely on *Armstrong* in reversing the order of confirmation, unlike the *Armstrong* plan, this was a case of gifting from secured credit to equity, and not from unsecured credit like in *Armstrong*. Further, unlike *Armstrong*, no classes of the same priority as the "gifters" objected, the only objectors being of a more junior class. While the *Armstrong* iteration was arguably the first test of its kind, something like

70. *Id.*
71. *Id.* at 210-15.
72. *Id.* at 212.
73. *Id.* at 211.
74. *In re* DBSD N. Am., Inc., No. 09–cv–10156 (LAK), 2010 WL 1223109, at *4-6 (S.D.N.Y. Mar. 24, 2010).
75. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79 (2d Cir. 2011). Two other issues were considered by the Second Circuit in the *DBSD* opinion. With respect to the second issue, the court answered the question of whether Sprint had standing to appeal as the holder of an indeterminate, unliquidated claim in the form of a pending lawsuit. The Second Circuit held by a 2-1 vote that Sprint did indeed have standing to appeal. *Id.* at 85. The third issue was whether the votes of DISH Network, a competitor who had purchased some of the secured creditor's claims for "strategic" reasons, had been properly designated and disregarded by the bankruptcy court. On this issue, the court upheld the decision below, holding that the designation of the votes was permissible. *Id.* at 104.
76. *Id.* at 85.

DBSD had already been done, for example in the *MCorp* case.[77] Therefore, the Second Circuit needed either to explicitly reject *SPM*, or go beyond the *Armstrong* logic in distinguishing *SPM*. The result, I would submit, was a correct decision based on the text of the Bankruptcy Code, but reveals a strained and confusing attempt to follow *Armstrong* and distinguish *SPM*.

The Second Circuit based its holding on a narrow interpretation of absolute priority, tracing the history of the rule to its origins in connection with the early railroad reorganizations leading up to *Boyd*, where shareholders in the failed entities would often come away with capital while junior creditors would take nothing.[78] The court found that the shares of DBSD were distributed "under the plan" and "on account of" its previous interest, and were thus in violation of the absolute priority rule. The first way in which the court distinguished *SPM* was on account of *SPM* being based on a Chapter 7 proceeding, while the *DBSD* plan was a Chapter 11 reorganization. The Second Circuit observed that the statutory absolute priority rule applies in Chapter 11, but not in Chapter 7.[79] *SPM* was also distinguished because the court found that the gifted property in *SPM* could have been be viewed as no longer part of the estate, since the automatic stay had been lifted in *SPM*, while DBSD's property remained part of the estate all along.[80] Up until this point, the Second Circuit's reasoning could be seen as closely tracking the Third Circuit in *Armstrong*. However, beyond these similarities, there is some divergence between the two holdings.

In rejecting the type of reasoning found in *SPM*'s progeny, the Second Circuit pointed to the Supreme Court's reasoning in its holdings on the new value doctrine, another doctrine applying the absolute priority rule.[81] The *DBSD* court found that the Supreme Court had indicated a preference for reading the absolute priority rule strictly.[82] The court also pointed to Congress's codification of the absolute priority rule and observed that Congress would have inserted a change, had it been their intention to update the existing understanding of the absolute priority rule at the time of

77. *See In re* MCorp Fin., 160 B.R. 941, 964 (S.D. Tex. 1993) (holding that in Chapter 11 liquidation proceedings, it would be permissible for junior creditors to be paid before senior creditors, based on asset distribution plans that "accord with the expectations of the statutes and the constraints of equity").

78. *DBSD II*, 634 F.3d at 94.

79. *Id.* at 98.

80. *Id.*

81. For a discussion of the new value doctrine, *see* Skeel, *supra* note 8, at 233-35.

82. *DBSD II*, 634 F.3d at 97 (citing Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999); Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988)).

the Code's enactment.[83] The court also examined the legislative history leading up to the enactment of the Code, and quoting the House Committee notes, observed that the "absolute priority rule was 'designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired.'"[84] While the circuit court noted the policy arguments for gifting, it also observed some policy reasons that it said favor a strict interpretation, particularly an incentive for "serious mischief between senior creditors and existing shareholders."[85] The court did not anywhere attempt to distinguish *Armstrong*'s heavy reliance on the fact that the gifting party in that case was not a secured, perfected creditor with a property interest, which of course was true of the gifting creditor in *DBSD*.

C. Analysis & Implications of the DBSD *Holding*

i. Analysis

The first, and possibly most important, critique of the legal reasoning in *DBSD* deals with its rationale for treating gifting differently in Chapter 11 than it would be treated in liquidations. This distinction provides virtually the only plausible justification for the Second Circuit purporting to accept both *SPM* and *Armstrong*, without rejecting one or the other, and this Section will contend that the distinction is rather puzzling from a legal standpoint. While it is correct that Section 1129(b)(2) only pertains to Chapter 11 proceedings, the Code still provides a distribution scheme for Chapter 7 proceedings, which lays out an order of distribution that is essentially the exact scheme that the absolute priority rule seeks to enforce even when a debtor's assets are not in fact liquidated and distributed.[86] The opinion does not address the question of why Congress would want to protect creditors in reorganizations, but not in liquidations. If anything, creditors would seem to need more protection in liquidation proceedings because of the finality of the matter. Here, with Sprint slated to receive equity possibly worth up to nearly half of the value of its original claim, the incentive is for everyone to maximize the value of the reorganized entity. Further, in the *Armstrong* case, the Third Circuit laid out three main avenues in which it distinguished the plan it was reviewing from the *SPM* plan:

83. *Id.*
84. *Id.* at 100-01 (quoting H.R. Rep. No. 95-595, at 416 (1977) *reprinted in* 1978 U.S.C.C.A.N. 5963, 6372).
85. *Id.* at 100.
86. 11 U.S.C. § 726 (2012).

> (1) *SPM* involved a distribution under Chapter 7, which did not trigger 11 U.S.C. § 1129(b)(2)(B)(ii); (2) the senior creditor had a perfected security interest, meaning that the property was not subject to distribution under the Bankruptcy Code's priority scheme; and (3) the distribution was a "carve out," a situation where a party whose claim is secured by assets in the bankruptcy estate allows a portion of its lien proceeds to be paid to others.[87]

If we were to apply this *Armstrong* test to the facts of *DBSD*, of the three distinguishing factors, only the first could be said to be sufficient to distinguish *DBSD* from *SPM* without rejecting *SPM*. Looking at the second factor, DBSD's creditor who provided the gifted consideration *did* have a perfected security interest,[88] and the distribution was similarly a situation where a secured creditor allowed some of its proceeds to be paid to others.[89] Further, the *SPM* plan was not entirely a carve out in the usual sense of the word, since it provided for recovery beyond administrative expenses.[90] Therefore, if the first of the three avenues—the difference between Chapter 7 and Chapter 11—was not found to be on solid legal footing, the *DBSD* court's attempt to distinguish its holding from *SPM* would be on shaky ground indeed. And as discussed earlier, neither of the circuit cases rejecting gifting have explained why it would be appropriate to circumvent the distribution scheme in Section 726 of the Code in a Chapter 7 proceeding, but not to circumvent the exact same order of priority in Section 1129 in a Chapter 11 case. Further, like *Armstrong*, the *DBSD* court makes no attempt to explain why the First Circuit gave the *SPM* plan its full blessing even though it was conceived in Chapter 11.[91] It also implicitly rejects the reasoning in *SPM*, stating, "creditors are generally free to do whatever they wish with the bankruptcy dividends they receive . . . ."[92] Therefore, while the facts in *Armstrong* lent themselves to the possibility of distinguishing the First Circuit's *SPM* holding while rejecting gifting in the *Armstrong* case itself, I would assert that *DBSD* provides no convincing facts distinguishing its rejection of gifting from *SPM's* approval of the practice, thus creating a split between the two circuits in all but name.

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87. *In re* Armstrong, 432 F.3d 507, 514 (3d Cir. 2005).
88. *In re* DBSD N. Am., Inc. (*DBSD I*), 419 B.R. 179, 214 (Bankr. S.D.N.Y. 2009).
89. *Id.* at 186.
90. *See* Levin, *supra* note 57 (explaining that a "carve out" generally refers to money set aside to pay for administrative expenses).
91. *See In re* Armstrong (*Armstrong II*), 432 F.3d at 518; *In re* SPM Mfg. Corp., 984 F.2d 1305, 1317 (1st Cir. 1993) (explaining that "we cannot find support for appellees' assertion that this agreement conflicts with any policy in favor of reorganizations manifested by Chapter 11").
92. *In re* SPM Mfg. Corp., 984 F.2d 1305, 1313 (1st Cir. 1993).

There are also some important ways in which *DBSD* diverges from the Second Circuit's *Armstrong* reasoning, despite both courts rejecting gifting in the context of a Chapter 11 plan. To the extent that the *Armstrong* court held that the claim of a senior creditor with a perfected security interest is "not subject to distribution under the Bankruptcy Code's priority scheme,"[93] *DBSD* rejects this analysis, as it holds that such a creditor is indeed subject to the priority scheme. Here one can see already where the Second Circuit's attempts to avoid declaring a circuit split and square its holding with the two prior circuit decisions are coming apart.

Another potentially troubling product of the *DBSD* holding is the court's reliance on two United States Supreme Court cases that it concludes "indicate a preference for reading the [absolute priority] rule strictly."[94] While this logic gives the Second Circuit a precedential hook for its holding, I would argue that it was not necessary and problematically calls the new value corollary into question. Acknowledging that the two Supreme Court cases did not address the scenario before it, the *DBSD* court asserts that the Supreme Court's "two post-Code cases on the rule are instructive. In both cases, the prior owners tried to avoid the absolute priority rule by arguing that they received distributions not on account of their prior interests but rather on account of the new value that they would contribute to the entity," going on to note that in both cases, the Supreme Court rejected those arguments.[95] In examining *203 N. LaSalle*, one would be hard-pressed to find a general preference for strict interpretation. In that case, the Supreme Court declined to issue a ruling on the general validity of a "new value" corollary to the absolute priority rule.[96] The "new value" corollary, the logic goes, allows a distribution to equity holders in a Chapter 11 case, not on account of their previous status as owners, but on account of "new value" being contributed to the reorganization.[97] Like the gifting doctrine, there is no reference in the 1978 Code to an exception for new value. However, the *203 N. LaSalle* court noted that although there is "no literal reference to new value" in the statute, it did "nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule . . . may carry a new value corollary."[98] While the Court did not rule on this issue, these words certainly appear to portray it as open to

93. *Armstrong II*, 432 F.3d at 514.

94. *DBSD II*, 634 F.3d at 97 (2d Cir. 2011) (citing Bank of Am. Nat'l Trust & Savings Ass'n v. 203 N. Lasalle St. P'ship, 526 U.S. 434, 437 (1999) [hereinafter 203 N. LaSalle] and Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988)).

95. *Id.*

96. 203 N. LaSalle, 526 U.S. at 449.

97. *Id.* at 443.

98. *Id.* at 449.

the possibility of reading a doctrine into Section 1129(b)(2)(B)(ii) that is not contained in the text of the statute—certainly not a general preference for strict interpretation of the statute. Instead, the Supreme Court adjudicated the case by determining what the phrase "on account of" within the statute means, considering three possible interpretations.[99] In fact, although the Supreme Court in *203 N. LaSalle* did not reach the validity of new value, it did recognize a procedural safeguard built into the new value doctrine—the requirement that the new value contributed be "reasonably equivalent" to property received in a reorganization.[100]

Considering the second Supreme Court case, *Norwest Bank Worthington v. Ahlers*,[101] which preceded *203 N. LaSalle* by ten years, we find similar language in dicta by the Court, where it stated that it did not wish to "comment on the continuing vitality of the . . . [New Value] exception."[102] The Court held that even if the new value exception did apply, it was not met by the parties in the case—farmers who retained an equity stake in their farm in return for their labor and expertise. The Court held that these factors would not count as measureable value.[103] Although the *Ahlers* court may not have read the applicable statute as liberally as some practitioners would have liked, affirming the vitality of new value, it again seems a stretch to proclaim that *Ahlers* stands for strict interpretation of Section 1129(b)(2)(B)(ii). In fact, some have opined that the *Ahlers* court failed to take a strict textualist approach to the Code, considering that it passed on the opportunity to hold invalid a doctrine that is nowhere stated in the statute.[104] By declaring that the two Supreme Court decisions on

99. *Id.* at 450-51. For a more thorough discussion of *203 N. LaSalle*, see Bruce A. Markell, LaSalle *and the Little Guy: Some Initial Musings on the Ultimate Impact of* Bank of America, NT & SA v. 203 North LaSalle Street Partnership, 16 BANKR. DEV. J. 345 (2000).

100. 203 N. LaSalle, 526 U.S. at 443, 445.

101. 485 U.S. 197 (1988).

102. *Id.* at 203-04 n.3.

103. *Id.* at 203-06. Inexplicably, the Second Circuit pointed out that the "continued cooperation and assistance" the existing shareholder of DBSD would contribute to the reorganized entity sounded a lot like the labor and expertise that was rejected as constituting new value by the Supreme Court in *Ahlers*. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79, 96 (2d Cir. 2011). I describe this as inexplicable because since a new value exception was not sought, the debtor neither claimed to or needed to offer anything of value to in order to satisfy § 1129(b)(2)(B)(ii) under the doctrine it sought to use in seeking confirmation.

104. *See* John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963, 1009-11 (1989) (explaining the Solicitor General's arguments (as Amicus Curiae) in *Ahlers* that the new value doctrine should be rejected and contending that, first, there had never been an adequate doctrinal basis for the new value exception, and alternatively, that the rule had been abolished by the Bankruptcy Code. The author argues that despite the plausibility of these arguments and what he called the "evanescent" nature of the new value exception, the Supreme Court *declined* to take a strict interpretation of the Code, as it could

Section 1129 indicate a general preference for strict interpretation, the *DBSD* court unnecessarily invites future courts to open the door to question the ongoing validity of new value in reorganizations.

In the end, while the *DBSD* court may have had difficulty trying to reconcile its holding with those found in *SPM* and *Armstrong* and grounding it in Supreme Court precedent, the reality is the plan that the *Boyd* court rejected almost a century ago was in some respects similar to the proposed plan in *DBSD*. In fact, the debtor in *Boyd* used the argument that since "there was nothing which could come to the unsecured creditors" because secured debts were undercapitalized, that "they, therefore, had no ground to complain if the bondholders were willing to give new shares to the old stockholders."[105] This argument bears a striking resemblance to that used by the *DBSD* Bankruptcy Judge, who held that:

> [I]f the secured creditor class is undersecured, that will mean, at least in most cases (as it does here), that any complaining creditor would get nothing anyway, whether or not the gift had been made—making it difficult, if not impossible, to see how the complaining creditor can be legitimately aggrieved by the gift.[106]

So, if *Boyd* is indeed still good law, then it would follow that the bankruptcy court did err in confirming DBSD's reorganization plan, by using the same logic that was dismissed in *Boyd*. When Congress enacted the Bankruptcy Code in 1978, it effectually codified the "fixed principle" from *Boyd* without any pertinent modification, thereby indicating an approval of the existing state of the doctrine, of which *Boyd* was a crucial part.[107]

Furthermore, the Second Circuit makes a compelling argument as to the intention of the framers of Section 1129 when it analyzes the House and Senate committee notes in support of a rule against gifting.[108] The logical

have done by holding that no new value exception existed).

105. N. Pac. Ry. Co. v. Boyd, 228 U.S. 482, 505 (1913).

106. *DBSD I*, 419 B.R. 179, 211 (Bankr. S.D.N.Y. 2009).

107. Congress did, in fact, change one aspect of the absolute priority rule when writing it into the Bankruptcy code. Under *Boyd*, a reorganization could not be confirmed in violation of the "fixed principle" even if all parties consented. Under the 1978 Code, a class must object in order for a violation to exist. *Compare* 11 U.S.C. § 1129(b)(1) (maintaining that a class must object in order for a violation to exist) *with Boyd*, 228 U.S. at 507 (holding that a reorganization could not be confirmed in violation of "the fixed principle" even if all parties consented).

108. *See DBSD II*, 634 F.3d 79, 100-01 (2d Cir. 2011) (citing a House Committee report referring to an earlier version of the bill which eventually became Section 1129(b)(2) with only minor stylistic changes, indicating that the rule was "designed to prevent a senior class from giving up consideration to a junior class unless every intermediate class consents, is paid in full, or is unimpaired.") (citation omitted).

question that follows is what the practical implications of the holding will be, and whether the concerns that were behind the *Boyd* decision are still present today as a reason for justifying the rule.

ii. Implications of the Holding.

The only two circuits that have considered the gifting doctrine since *SPM* are the Second and the Third. As both have rejected gifting in the cases before them, firms representing parties in bankruptcies in these circuits need to find other ways to advise their clients to reach consensus where gifting might have previously been viable. As these two circuits have in their jurisdiction the two largest forums for complex corporate reorganizations—the District of Delaware and the Southern District of New York[109]—the disapproval of the practice is likely to have more effect than the holdings of two circuits might in another area of the law. It is likely that as future Chapter 11 filings arise, the new narrower interpretation of the absolute priority rule will restrict the parties' abilities to explore certain types of compromises in complex reorganization attempts. As an example, the Worldcom bankruptcy (confirmed prior to both the *Armstrong* and *DBSD* holdings) was recently declared the third-largest bankruptcy of all time, and at the time of its filing, was the largest.[110] Use of the gifting doctrine was one of the mechanisms implemented during that colossal reorganization. The bankruptcy court reviewing Worldcom's plan summarily held that "enhanced value received by holders of [unsecured] claims on account of contributions from other Classes is not a treatment of these Claims under the plan and does not constitute unfair discrimination."[111] Without a detailed discussion, the court further stated that "[c]reditors are generally free to do whatever they wish with the bankruptcy dividends they receive, including sharing them with other creditors."[112] The change in the state of the law in the eight years between *Worldcom* and *DBSD* is striking, as it is unlikely any bankruptcy court in any circuit today could summarily approve a plan including gifting as it did in *Worldcom*, without at least some effort to distinguish *DBSD* and *Armstrong*. While in *Worldcom* the gifting was from one class of creditors

109. Bankruptcy by the Numbers, *supra* note 58.

110. Shira Ovide, *MF Global: Likely among the 10 biggest bankruptcies ever*, WSJ BLOGS (Oct. 31, 2011, 10:38 AM), http://blogs.wsj.com/deals/2011/10/31/mf-global-likely-among-the-10-biggest-bankruptcies-ever/.

111. *In re* Worldcom, Inc., No. 02-13533(AJG), 2003 WL 23861928, at *60 (Bankr. S.D.N.Y. Oct. 31, 2003) (citing *SPM*, 984 F.2d 1305 and *MCorp*, 160 B.R. 941) [hereinafter Worldcom].

112. *Id.* at *61.

to a more junior class, it is highly likely that applying the current interpretation of the absolute priority rule governing the Second Circuit, this plan of reorganization could have been rejected.[113]

Prior to *DBSD*, it was thought that gifting was more controversial when coming from unsecured creditors. The main case disapproving of gifting—*Armstrong*—spent a considerable amount of time explaining why courts should be more wary in this situation than if secured creditors were giving up part of their recoveries. However, *DBSD* took *Armstrong* a step further, in disapproving of gifting by a secured creditor—one with a property interest in that which is being gifted. As a result, advisors in any jurisdiction must consider the possibility that bankruptcy and district courts will follow the *Armstrong* and *DBSD* rulings. The limits on acceptable parameters within a plan will result in practitioners working around these issues at an earlier stage in bankruptcy proceedings. Therefore, the ruling has the potential to be a game changer, at least in certain Chapter 11 cases.

It is also easy to see how an attack could be formed on the new value corollary using the same logic that the *DBSD* court expounded. Just as gifting is found nowhere in the 1978 Code, the new value corollary also is not codified. *Ahlers* and *203 N. LaSalle* refused to affirm the existence of the new value corollary, so critics of the decision will point out that it invites parties to the next Chapter 11 filing who want to hold off confirmation to argue that the new value exception is also not within the plain meaning of the Code. The one difference, of course, is that prior to the enactment of the Code, the Supreme Court had arguably held in favor of a new value exception in *Case v. Los Angeles Lumber Co*.[114] However, the last time that it took a case on the absolute priority rule, the Supreme Court observed that the vitality of new value based on this reasoning is far from clear. First, it pointed out that the concept of new value "never rose above the technical level of dictum in any opinion of this Court."[115] The Supreme Court went on to observe that Congress could have included a provision in the Code that would allow exceptions for contributions of new value, but chose not to do so, despite debating several proposed revisions to the absolute priority rule.[116] Therefore, there is no clear answer to this question. One side will argue that *Los Angeles Lumber* sanctioned the new

113. See Miller & Berkovich, *supra* note 16, at 1398-1405 for a detailed discussion of the *Worldcom* plan. Miller and Berkovich, ardent proponents of gifting, acknowledge that *Worldcom* arguably took the gifting doctrine too far even before the cases reining in the practice. *Id.* at 1404.

114. 308 U.S. 106 (1939).

115. Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle P'ship, 526 U.S. 434, 445 (1999).

116. *Id.* at 446–47.

value doctrine, and Congress took the state of the law as it found it when it enacted the Bankruptcy Code. However, the response, which is solidified by the plain meaning approach that *DBSD* takes, is that Congress would have simply codified the new value doctrine if they intended it to be a valid exception or corollary to the absolute priority rule, just as they changed the rule to allow confirmation of plans with no objecting classes as discussed earlier. Whether a new value corollary or exception is necessary or valuable is beyond the scope of this Comment; however, suffice it to say that many academics and practitioners have commented on its importance and observed that complex reorganizations would often become far more difficult to effect without it.[117] Many agree with the policy rationale that the *Los Angeles Lumber* court itself recognized, which is that allowing existing equity holders to contribute capital is an important consideration as they may be the best source of cash for a reorganization.[118]

The current state of gifting under *DBSD* results in a partial shift in leverage from equity holders to out-of-the-money, unsecured creditors. As the Second Circuit recognized, Sprint did not object to the plan because it was unhappy with the amount it was receiving. Indeed, if all efforts to reorganize failed and DBSD had been liquidated, Sprint would have received nothing. Most unsecured creditors in this position object for leveraging or strategic purposes. Indeed, Sprint may have wanted to use its leverage to increase its share in the reorganized entity.[119] The Second Circuit holding thus shifts some of the power to hold up a reorganization plan away from shareholders to creditors. This power may diverge at times from a maximum-recovery standard. As the bankruptcy court pointed out, Sprint would have done considerably better under the plan it opposed than

117. *See* David R. Kuney & Timothy R. Epp, *Aftermath of* Bonner Mall*: Evolution or Regression in the Notion of "New Value"?*, 5 J. BANKR. L & PRAC. 211 (1996) (arguing that the new value doctrine as an exception to absolute priority is critical to the practice of bankruptcy law and reorganization); Charles W. Adams, *New Capital for Bankruptcy Reorganizations: It's the Amount that Counts*, 89 NW. U. L. REV. 411 (1995) (arguing that reorganizations have historically been more efficient when shareholders provide new capital in a reorganization, and discussing problems with turning creditors into owners); Miller & Berkovich, *supra* note 16, (arguing that the new value should be recognized); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9 (making the case that new value is permitted under the Code, and is incorrectly called an "exception" because its use does not violate the absolute priority rule to begin with if old equity's participation is not on account of its former equity interest). *But See* Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991) (arguing that the new value corollary or exception unfairly impairs the rights of unpaid creditors in favor of debtor control, has no justification under the Bankruptcy Code, and should be rejected).

118. Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 121 (1939).

119. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79, 92 (2d Cir. 2011).

it had a right to do from a liquidation standpoint. The Second Circuit, however, was clear to emphasize that whether the plan was in Sprint's best interests was not relevant—the court clearly thought that it should be left to Sprint to object to the plan if it believed the plan was not in its best interests, whether that was a good business decision or not. Sprint's opposition, despite its potential considerable recovery as an "out-of-the-money" unsecured creditor, shows that its objective was likely bargaining leverage.

The recent developments restricting gifting arguably serve to balance the power during reorganization, rather than redistribute it all to creditors. After all, equity holders are not without their own leverage in reorganizations, even without the ability to make a deal with secured creditors involving gifts. For example, equity holders sometimes have the ability to compel a shareholder meeting for the strategic purpose of electing a new board during reorganization proceedings.[120] Furthermore, if shareholders perceive that they will walk away empty-handed, they can threaten to proceed with costly valuation rather than propose a plan in which they take nothing.[121] In addition, during the first 120 days after filing, the debtor has the exclusive right to propose reorganization plans, a power that can be extended to as long as eighteen months.[122] In a case survey, Lynn LoPucki and William Whitford found that extensions beyond the 120 days are granted quite routinely.[123] And if each class agrees to a plan, it will be confirmed, even if it results in a distribution to the "old" equity holder. Since equity holders have a number of sources of leverage even without the ability to "cram-down" a plan involving gifting, perhaps the better balance of bargaining power is to allow unsecured creditors the bargaining chip of being able to object to a plan, such as the one proposed by DBSD here.

As future bankruptcy cases arise, the *DBSD* holding will no doubt spur creativity on the part of practitioners, as restrictive holdings tend to do. Interestingly, one debtor sought to confirm a plan involving such a creative "gift" shortly prior to *DBSD*. In *In re Journal Register Co.*, a

120. *See In re* Johns-Manville Corp., 801 F.2d 60, 64 (2d Cir. 1986) (holding that the right to call a shareholders meeting continues with a debtor-in-possession during reorganization). *But see* Lynn M. LoPucki & William C. Whitford, *Preemptive Cram Down*, 65 AM. BANKR. L.J. 625, 635 (1991) (explaining that in certain situations, former equity holders can no longer call shareholder meetings during Chapter 11).

121. *See* Lynn M. Lopucki & William C. Whitford, *Bargaining over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) (explaining that parties often compromise their interests so as to avoid the time and expense involved in valuation).

122. 11 U.S.C. § 1121 (2012).

123. Lopucki & Whitford, *supra* note 121, at 128.

bankruptcy court in the Southern District of New York approved a Chapter 11 plan in which a distribution was voluntarily diverted from secured creditors to trade creditors to ensure goodwill.[124] The plan carefully stipulated that it be placed in a "so-called trade account" that was explicitly designated not to be property of the debtors.[125] It will be interesting to see whether such a method of short-circuiting the no-gifting rule in the Second Circuit would be successful if tested after *DBSD*, although it would seem unlikely.

IV. THINKING AHEAD TO A SUPREME COURT RULING ON THE MATTER

A. Why the Issue is Ripe for Supreme Court Adjudication

The last time the Supreme Court granted *certiorari* on an absolute priority case, a similar circuit split had developed.[126] The time before that was in *Ahlers*, where although no circuit split existed, the case had been heard by the Eighth Circuit and there was a vigorous dissent.[127] Neither of those cases resolved the issue of whether a new value corollary exists post-enactment of the Bankruptcy Code. This issue, on the other hand, would be a good opportunity to eliminate confusion over which principles taken from the complex and often contradictory framework of First, Second, and Third Circuit cases on absolute priority discussed in this Comment are to be applied in future bankruptcies. Additionally, because the two prior Supreme Court cases did little to provide rules to apply in future filings, the Supreme Court could take advantage of this opportunity to lay down a clear rule. In addition, while the Court would not likely be able to rule on new value at the same time as gifting, it would be possible to dismiss gifting using reasoning that could not be applied to militate against new value, in contrast to the Second Circuit's recent decision.[128]

124. *In re* Journal Register Co, 407 B.R. 520, 527 (Bankr. S.D.N.Y 2009).

125. *Id.*

126. *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle P'ship, 526 U.S. 434, 443 (1999) (detailing the circuit splits between the Seventh and Ninth Circuits, and the Second and Fourth Circuits).

127. Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988) (Gibson, J. Dissenting).

128. Following the Second Circuit's decision, DBSD pursued a sale rather than a new plan proposal, and evidently chose not to pursue a petition for *certiorari*. DISH Network Corp. agreed to acquire the debtor out of bankruptcy several months after the decision was announced by the Second Circuit, and the sale was approved by the FCC in March 2012. Joseph Checkler, *Judge Says DBSD Can Move Forward With Sale to Dish Newtork*, Dow Jones News Service, Mar. 15, 2011; Anton Troianovski and Amy Schatz, *Corporate News: FCC Deals a Setback to Dish's Wireless Network Plans,* Wall St. J., Mar. 5, 2012, at B3.

B. Why the Court Should Reject Gifting, While Distinguishing New Value

The arguments in favor of gifting are significantly weaker than those in favor of new value, from both a policy and a doctrinal perspective. Should the Supreme Court accept this case or a future one involving the gifting doctrine, the Court would thus do well to be mindful that the specific reasoning relied upon may well influence the vitality of new value. After all, the *DBSD* court relied in part on the Supreme Court's past new value decisions to invalidate gifting.[129] Since new value is a doctrine that the Bankruptcy Bar has long relied on, and academics, practitioners, and even the Supreme Court have recognized the importance of raising new capital from existing shareholders, the Supreme Court should be wary of chipping away at this doctrine.[130] Further, the new value rule has an important safeguard to prevent abuse—the value received must be "reasonably equivalent" to new capital contributed, which ensures that existing shareholders do not use the rule as an end run around the absolute priority rule.[131] Without a comparable safeguard in the gifting context, courts have reason for concern that gifting could be used in nefarious manners, even if the parties in *DBSD* had no such intent. Indeed, the Second Circuit warned about "serious mischief" should this type of gifting arrangement be sanctioned by the courts.[132] Presumably, the court was worried because the old equity holder who is on the receiving end of the five percent "gift" is the same entity that is crafting the reorganization plan. Perhaps the court was concerned that although the unsecured debtholder was not injured here, in some other case, the plan proponent might conveniently inflate the amount of a creditor's priority claim when crafting the plan in exchange for a generous "gift."[133]

In developing the legal reasoning, the legislative history approach that the *DBSD* court mentioned in passing would be a good place to start. The House and Senate committee notes preceding the adoption of the Bankruptcy Code could be weighed in formulating a rule in a way that would properly dismiss the gifting doctrine as used over the past two

129. *In re* DBSD N. Am., Inc. (*DBSD II*), 634 F.3d 79, 97 (2d Cir. 2011).

130. *See supra* text accompanying notes 113–17 (providing examples of academic support for raising new capital from shareholders).

131. 203 N. LaSalle, 526 U.S. at 442-45 (1999).

132. *DBSD II*, 634 F.3d at 100.

133. *But see* Miller & Berkovich, *supra* note 16, at 1408-12 (describing what would likely be the practitioners' rejoinder to the concerns about mischief—citing cases in which Bankruptcy courts have rejected plans in which gifting was used for nefarious or improper ends, such as *In re* Scott Cable Comm's Inc., 227 B.R. 596 (Bankr. D. Conn. 1998) and *In re* Goffena, 175 B.R. 386 (Bankr. D. Mont. 1994)).

decades, while clearly signaling that the new value doctrine is not in question. As briefly discussed in *DBSD*, the Congressional Commission assigned to make recommendations pertaining to the Code suggested allowing equity owners to retain an interest if they would contribute something essential, such as expertise, to the business.[134] However, Congress decided not to create an exception for gifts, although they did make some changes to the existing framework, such as only allowing classes of creditors, rather than individual creditors, to invoke the rule.[135] But the story is not exactly the same when one ponders the legislative history with a mind toward the new value corollary. The very fact that the Bankruptcy Commission, in trying to make absolute priority more fluid, considered changing the rule to allow non-monetary new value contributions appears to indicate that they never even considered the possibility that monetary contributions would not be permitted. In fact, a proposed bill containing non-monetary new value was introduced several times, and the House engaged in "extensive hearings" on the proposed bills.[136] Certainly the Committee did not intend to allow non-monetary new value contributions, but reject the more important monetary contributions often necessary to achieve reorganization, that were understood by many to be already sanctioned by *Los Angeles Lumber*. Therefore, a ruling that focuses on the legislative history would likely be quite effective in reaffirming Congress's purpose in making the changes that it wanted and leaving out those it did not desire. In addition, while the question of whether *Los Angeles Lumber* firmly established new value can be debated, what is not in question is that there was no Supreme Court analogue approving of gifting prior to the enactment of the Code. Using these lines of reasoning, the Court could effectively affirm the Second Circuit on somewhat different grounds without calling into question firmly entrenched doctrine.

Should the Court take a gifting case, it may also have the choice between limiting its holding to the Chapter 11 cases, or issuing a broad ruling that would also cover Chapter 7. Although the legislative history leading up to the enactment of Section 1129 would not work to strike down gifting in a Chapter 7 scenario, if the holding restricts the practice of gifting, it is difficult to articulate a policy or statutory rationale why gifting in Chapter 7 should be permitted. Courts should have the same reasons to be wary of abuse by junior classes in Chapter 7 proceedings that exist in

134. *See* Markell, *supra* note 117, at 88-89 nn.116, 117 (citing Bankruptcy Commission of the United States, Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. 137, 93d Cong., 1st Sess. (1973)).

135. *Id.*

136. 203 N. LaSalle, 526 U.S. at 446-47.

Chapter 11. Further, there is nothing in the Chapter 7 distribution scheme statute to indicate that it was meant to be more malleable or less absolute than Section 1129.

In formulating a rule for ascertaining the plain meaning of provisions in the Bankruptcy Code, the Supreme Court would also do well to be wary of grounding a holding on "plain meaning" in any sense that does not involve legislative history. Such a holding would be likely to be used in the lower courts to attempt to chip away at the new value line of cases.

C. *What the Holding Likely Would Be*

In a recent and instructive case, the Supreme Court held in favor of a narrow reading of the Bankruptcy Code by a 9-0 vote in *Milavetz, Gallop & Milavetz, P.A. v. United States*.[137] The *Milavetz* Court declined an invitation to take a creative view of several provisions of the portion of the Bankruptcy Code at issue before it.[138] In another recent Supreme Court decision applying the Bankruptcy Code, *Marrama v. Citizens Bank*,[139] the Court decided by a 5-4 vote that a bad-faith exception could be implied into Section 1307(c), allowing dismissal of a bankruptcy filing for pre-petition bad-faith conduct.[140] This is notwithstanding the fact that the statute mentions ten causes justifying that relief, none of which is prepetition bad faith conduct.[141] The four dissenters, led by Justice Alito, would have followed the plain language of the statute and would not have implied a bad-faith exception, holding that a bankruptcy court's "general and equitable powers 'must and can only be exercised within the confines of the Bankruptcy Code.'"[142] While it might seem that this case would imply that the Court is open to reading language into the Code on policy grounds, I would posit that the case against gifting is an easier case to make based on plain language, and for that reason the same four dissenters, all of whom are still on the Court, would find that gifting is not implied in Section 1129(b), and would be joined by at least one other justice, due to the fact that it is a clearer case.[143]

137. 130 S. Ct. 1324 (2010).

138. *See id.* at 1331-32 (explaining how the Court arrived at its definition of the term "debt relief agency").

139. Marrama v. Citizens Bank, 549 U.S. 365 (2007).

140. *Id.* at 371.

141. *Id.* at 373.

142. *Id.* at 382 (Alito, J. Dissenting) (citing Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988)).

143. It is recognized by the author that based on their judicial philosophies, some of the four justices in the Marrama dissent, most notably Justice Scalia, would be unlikely to join an opinion relying on legislative history, as proposed in part B of this section. Another

CONCLUSION

Whether the Supreme Court would be inclined to hold in favor of gifting, however, does not answer the question of whether a narrow interpretation of the absolute priority rule is necessary to prevent the evils that the *Boyd* Court was concerned with nearly a century ago. The railroad reorganizations of that time involved an enormous part of the nation's economy. By 1915, approximately half of the nation's railroads had defaulted on their debt.[144] As of 1906, twelve billion of eighteen billion dollars in outstanding railroad securities were held by the public.[145] The most efficient method of reorganizing came to be the equity receivership.[146] Bondholders and shareholders would work together—or collude, depending on one's viewpoint on this kind of collaboration—to reorganize. In essence, the bondholders were often able to have their own claims satisfied, squeeze out unsecured creditors so they would receive nothing, and shareholders would receive new equity for a fraction of its actual value.[147] Looking at the developments leading up to *Boyd* from this perspective, it is unsurprising that the Court determined the need for a "fixed principle." While the recent practice of gifting is probably not authorized under the existing Bankruptcy Code, a Supreme Court ruling handing down a definitive answer to that question will provide needed clarification for bankruptcy advisors. Perhaps bankruptcy attorneys will find efficient ways to achieve reorganizations without the option of gifting. Or, a consensus might develop that gifting in limited circumstances does add value systemically, and the proper safeguards can be effectively applied to prevent the type of abuse prevalent in the *Boyd* era. In that instance, perhaps a legislative approach would be the best solution.

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recent Supreme Court case interpreting the Bankruptcy Code is *RadLAX Gateway Hotel, LLC et al. v. Amalgamated Bank*, where the Court held in an 8-0 decision that Section 1129(b)(2)(A) of the Code should not be read in a manner that is "hyperliteral and contrary to common sense." 132 S. Ct. 2065, 2070 (2012). While not related in any substantive manner, this recent opinion may also be instructive on the potential outcome of a gifting decision. While a case could be made that it would take a similar "hyperliteral," aggressive texualist interpretation of the Code to invalidate the new value doctrine, gifting would be much easier to invalidate under a traditional plain-language approach. For further discussion of the *RadLAX* decision, see Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, 32 No. 7 BANKR. LAW LETTER 1 (July 2012).

144. WILLIAM Z. RIPLEY, RAILROADS: FINANCE & ORGANIZATION 374 (1915).

145. *Id.* at 62-63.

146. *See* Markell, *supra* note 117, at 75 (explaining the efficiency of the equity receivership for railroads).

147. *See* Swaine, *supra* note 7, at 914-17 (detailing the process by which reorganization occurs in this manner).

Nothing would prevent the bar from lobbying for an amendment to the Bankruptcy Code explicitly permitting gifting in certain circumstances and with certain stipulations, perhaps similar stipulations to those proposed leading up to the enactment of the 1978 Code. This approach would be preferable to the confusing web of cases that are presently on the books as controlling law.